DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 04-0067
Income Tax
For Tax Years 1999-2001

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ISSUES

I. Adjusted Gross Income Tax—Combined Filing Status

Authority: Harrington v. State Board of Tax Commissioners, 525 N.E. 2d 360 (Ind. Tax 1988); Johnson v. Kosciusko County Drainage Board, 594 N.E. 2d 798 (Ind. App. 1992); IC 6-3-2-2; IC 6-8.1-5-1

Taxpayer protests the Department's decision to require filing a combined return.

II. Tax Administration—Negligence Penalty

Authority: IC 6-8.1-10-1; IC 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer operates businesses at several Indiana locations. As the result of an audit, the Indiana Department of Revenue ("Department") determined that taxpayer should file a combined return with related companies forming a unitary group and issued proposed assessments. The related companies interact with each other in a variety of ways, including filing as a consolidated group for Federal income purposes, and taxpayer does not disagree that there is a unitary group. Taxpayer protests the determination that it should file combined returns, the proposed assessments, and the negligence penalty. Further facts will be supplied as required.

I. Adjusted Gross Income Tax—Combined Filing Status

DISCUSSION

Taxpayer protests the determination that it should file combined returns with related companies in the unitary group. Taxpayer also protests the imposition of additional adjusted gross income tax for the tax years in question. The Department conducted an audit of taxpayer and determined

that a combined return was necessary to fairly reflect the unitary group's income derived from sources within the state of Indiana. Both taxpayer and the Department agree that the affiliated companies constitute a unitary group. Taxpayer believes that the existence of a unitary group does not automatically require combined filing and that its method of filing as a single company fairly reflected taxpayer's Indiana source income. Taxpayer offers several arguments in support of its protest.

First, taxpayer states that the Department cannot force taxpayer to report its Indiana taxable income on a combined basis without first providing evidence that the separate filing does not fairly reflect Indiana source income. The Department refers to IC 6-8.1-5-1(b), which explains that the notice of proposed assessment is itself prima facie evidence that the Department's claim for unpaid tax is valid and that the burden of proving the claim wrong rests with the taxpayer. Nevertheless, the audit report does list the relationships of the companies involved and provides calculations explaining how the assessments were reached.

Next, taxpayer states that the Department cannot simply force a taxpayer to file a combined return without first showing that the filing method it used does not fairly reflect or represent Indiana source income. The relevant statute is IC 6-3-2-2, which states in relevant parts:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
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> (1) income from real or tangible personal property located in this state;
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> (2) income from doing business in this state;
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> (3) income from a trade or profession conducted in this state;
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> (4) compensation for labor or services rendered within this state; and
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> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.
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> …
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> (b) Except as provided in subsection (*l*), if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3).
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> …
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> (*l*) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting;
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> (2) the exclusion of any one (1) or more of the factors;
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> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana;

> or
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
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> (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.
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> …
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> (o) Notwithstanding subsections (*l*) and (m), the department may not, under any circumstances, require that income, deductions, and credits attributable to a taxpayer and another entity be reported in a combined income tax return for any taxable year, if the other entity is:
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> (1) a foreign corporation; or
>
> (2) a corporation that is classified as a foreign operating corporation for the taxable year by section 2.4 of this chapter.
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> (p) Notwithstanding subsections (*l*) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (*l*) and (m).

Taxpayer's protest states:

> IC 6-3-2-2(*l*) grants the Department authority to force a combined filing **if, and only if**, the statutory apportionment method used "…does not fairly represent the taxpayer's income derived from sources within the state of Indiana…."

Taxpayer then states:

> This precondition is reemphasized later in the same statute, which states: "…the department may not require that income, deductions, and credits attributable to a taxpayer and another entity…be reported in a combined return **UNLESS** the department is unable to fairly reflect the taxpayer's adjusted gross income…." IC 6-3-2-2(p)(emphasis added).

As IC 6-3-2-2(*l*)(4) plainly states, the Department is permitted to employ any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. Also, as previously explained, the audit report includes calculations detailing how the Department determined the amounts of the proposed assessments. The auditor used the apportionment methods provided in IC 6-3-2-2 to determine the Indiana apportionment factor. As explained in the audit report, the Department believes that a combined return is the only proper method to fairly allocate and apportion this taxpayer's income, as provided in IC 6-3-2-2(p)

Taxpayer refers to a previous Letter of Findings (LOF) issued to an unrelated party in which the Department decided that the taxpayer should not file a combined return. In that LOF, the Department determined that most of the companies in that unitary group did not have nexus with Indiana and had no Indiana source income. The Department ruled that since the companies had no Indiana source income, but did have out-of-state losses, the only reason to include those companies would be to dilute income received by the two companies which did have Indiana source income. Since this would not fairly reflect Indiana adjusted gross income tax, the Department denied that taxpayer's protest to file a combined return.

Taxpayer believes that in the instant case, since it too has companies with no Indiana nexus, then those companies should not be included in a combined return. The fundamental difference is that here the non-Indiana nexus companies do have Indiana-source income. Taxpayer protests that merely being in a unitary group does not automatically require combined filing. Taxpayer is correct that unitary status is not the sole determining factor. However, combined filing is required if members of a unitary group are deriving income from Indiana sources. In this case, members of the unitary group are deriving income from Indiana sources and combined filing is required to fairly reflect the group's Indiana adjusted gross income tax, as provided by the various subsections of IC 6-3-2-2.

Taxpayer also protests that the Department has not promulgated regulations that specifically set forth objective standards to determine whether a taxpayer's use of the statutory apportionment scheme does or does not fairly reflect their Indiana source income. Taxpayer refers to several court cases to establish that Indiana has an "ascertainable standards" rule requiring state agencies to set out rules for those who may have contact with those agencies. In Harrington v. State Board of Tax Commissioners, 525 N.E. 2d 360 (Ind. Tax 1988), the court explained:

> In order to satisfy due process, an administrative decision must be in accord with previously stated, ascertainable standards. This requirement is to make certain that administrative decisions are fair, orderly and consistent rather than irrational and arbitrary. The standards should be written with sufficient precision to give fair warning as to what the agency will consider in making its decision. And finally, the standards should be readily available to those having potential contact with the administrative body.
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> Id., at 361.

In Johnson v. Kosciusko County Drainage Board, 594 N.E. 2d 798, 803 (Ind. App. 1992), the court further clarified, "However, these standards need only be as specific as circumstances permit considering the purpose to be accomplished." The Department believes that its regulations are as specific as circumstances permit considering their purpose. Taxpayer believes that the Department's regulations do not meet this standard, but offers insufficient evidence and analysis to support this position.

Taxpayer also protests that the audit does not give credit for taxes already paid by the previously single-filing member of the unitary group. These taxes flow from Indiana source income. The Indiana source income is included in the apportionment formula used to reach the unitary group's Indiana apportionment percentage. Therefore, taxpayer should get credit for taxes already paid on Indiana source income for these tax years.

In conclusion, the Department is permitted to require combined filing by a unitary group if it fairly reflects Indiana source income, under the various provisions of IC 6-3-2-2. In this case, combined filing does fairly reflect Indiana source income of the unitary group. The proposed assessment is prima facie evidence that the claim for unpaid tax is correct, and the burden is on the taxpayer to prove the proposed assessment incorrect, under IC 6-8.1-5-1(b). Taxpayer has not met this burden. The Department's regulations meet the "ascertainable standards" requirement of Harrington, by being as specific as circumstances permit considering their purpose, as explained in Johnson. Taxes previously paid on Indiana source income should be credited and taken into account when calculating the unitary group's assessment.

FINDING

Taxpayer's protest is denied regarding combined filing status and sustained regarding credit for taxes previously paid.

II. Tax Administration—Negligence Penalty

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty and interest for the tax years in question. Taxpayer protests the imposition of penalty and interest. Taxpayer states that interest should be calculated on the amount of tax left after it is credited with taxes previously paid by the single filer member of the unitary group. With regard to interest, the Department refers to IC 6-8.1-10-1, which states in relevant part:

> (a) If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on his return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.
> …
> (e) The department may not waive the interest imposed under this section.

Since taxpayer incurred a deficiency upon a determination by the Department, as explained in Issue I, the Department may not waive interest under IC 6-8.1-10-1. However, the interest should be calculated on the correct amount of tax, which would constitute the underpayment after crediting tax already paid.

With regard to the penalty, the Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

> If a person:
> …
> (3) incurs, upon examination by the department, a deficiency that is due to negligence;
> …
> the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC 6-8.1-10-2.1(a). Taxpayer has affirmatively established by documentation and explanation that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c). The interest cannot be waived, under IC 6-8.1-10-1, but will be calculated on the amount of unpaid tax after credit is given for taxes already paid. The negligence penalty shall be waived.

FINDING

Taxpayer's protest is sustained.

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